Decision **PROPOSED DECISION OF ALJ PULSIFER** **(Mailed 11/14/2012)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Reform the Commission's Energy Efficiency Risk/Reward Incentive Mechanism.	Rulemaking 12-01-005 (Filed January 12, 2012)

DECISION REGARDING PRIORITIES FOR PROSPECTIVE ENERGY EFFICIENCY INCENTIVE REFORM

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DECISION REGARDING PRIORITIES FOR PROSPECTIVE ENERGY EFFICIENCY INCENTIVE REFORM

1. Introduction

In this decision, we provide guidance regarding our priorities for addressing reforms to the Energy Efficiency (EE) Risk/Reward Incentive Mechanism (RRIM). Relevant statute,[1] California's Energy Action Plan,[2] and past Commission decisions all prioritize EE as the first resource to meet California's energy demand. The RRIM was originally designed to extend California's commitment to making EE the highest energy resource priority.

As observed in D.07-09-043, the investor-owned utilities (IOUs) have an inherent bias toward supply-side procurement under cost-of-service regulation. The RRIM was thus devised to overcome this bias by offering earnings opportunities to motivate IOU investors and managers to view energy efficiency programs as a core part of regulated operations.

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1 Public Utilities Code Section 454.5(b)(9)(c) states: "The electrical corporation will first meet its unmet resource needs through all available energy efficiency and demand
reduction resources that are cost effective, reliable, and feasible."

2 The Energy Action Plan identifies specific goals and actions to ensure adequate, reliable and reasonably-priced electrical power and natural gas supplies through cost-effective and environmentally sound strategies. The Energy Action Plan is posted on the Commission's website at
http://www.cpuc.ca.gov/static/energy/electric/energy+action+plan/index.htm.
See also, Decision (D.) 05-09-043, *mimeo.*, at 15; Energy Efficiency Policy Manual Version 3 (Policy Rules), Rule II.2 (Attachment 3 to Decision (D.) 05-04-051).

In previous decisions, we approved RRIM awards for the 2006-2008 budget cycle and for the 2009 bridge year.[3] The most RRIM awards were approved in December 2011 (covering 2009 bridge year programs). For the reasons outlined below, however, no mechanism has yet been adopted to provide for incentive awards for the 2010-2012 cycle. Uncertainty has remained regarding whether, and if so, how a mechanism may be adopted and applied for incentive earnings for the 2010-2012 cycle. In this decision, we resolve this uncertainty.

Although we remain fully committed to making EE the highest energy resource priority, we conclude that expending further resources to devise a mechanism for incentive earnings for the 2010-2012 cycle would not advance that commitment. An incentive mechanism, to be effective, should be in place at the start of a program cycle, if not when the cycle was being designed by utilities. Adoption of any incentive mechanism for 2010-2012 at this point would be backward looking, however, and thus too late to have a material effect on effective management of 2010-2012 programs. Accordingly, we shall not expend further resources to consider or implement an incentive mechanism covering the 2010-2012 program cycle.

We intend for the next EE program cycle to begin on January 1, 2013.[4] Spending further resources to devise an incentive mechanism for the 2010-2012

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[3] For the 2006-2008 cycle, incentive earnings were awarded in three installments: December 2008, December 2009, and a final payment in December 2010.

[4] The 2013-2014 EE Portfolios are currently under consideration in Application 12-07-001 et al. The Commission gave guidance on the portfolios in D.12-05-015.

cycle would distract from our priority focus on effective 2013-2014 reforms. By making the determination not to divert further resources looking backward, we free up resources to move forward with our priority goal of timely developing and implementing an effective incentive program for the 2013-2014 cycle. In making this decision, we continue to affirm the value of effectively designed incentives to pursue all cost-effective conservation and EE measures rather than expanding supply-side resources.

As we prioritize a focus on devising effective incentives for the 2013-2014 cycle, we reaffirm our commitment to promoting energy efficiency goals as a top priority.

2. Procedural Background

This decision addresses the issue of Commission priorities for pursuing Energy Efficiency (EE) incentive reform, and more specifically, whether any incentive mechanism should be further pursued for the 2010-2012 program cycle. A subsequent decision will address incentive reforms applicable to the 2013-2014 cycle. The active parties in this proceeding are the investor-owned utilities (IOUs), Pacific Gas and Electric Company (PG&E), Southern California Edison Company (SCE), and the "Joint Utilities" (i.e., San Diego Gas & Electric Company (SDG&E) and Southern California Gas Company (SoCalGas)). Intervenors include the Commission's Division of Ratepayer Advocates (DRA), The Utility Reform Network (TURN), the Natural Resources Defense Council (NRDC), National Association of Energy Service Companies, California Energy Efficiency Council (Efficiency Council), and Women's Energy Matters (WEM).

The Commission originally adopted the Risk/Reward Incentive Mechanism (RRIM) in Decision (D.) 07-09-043 in September 2007. Within its first year, however, it became apparent that the RRIM was not working as intended.

The Commission thus opened Rulemaking (R.) 09-01-019 to address RRIM reforms. Initial reforms were to be considered first, to apply to the 2006-2008 program cycle, and more extensive reforms were to apply for programs implemented after that cycle.

The Commission adopted limited RRIM reforms in conjunction with incentive awards granted for the 2006-2008 cycle. The next budget cycle was originally anticipated to cover 2009-2011. Due to various factors including adoption of the Strategic Plan and the need for significant revision to utility portfolios, however, the next cycle was deferred. The Commission adopted bridge funding (D.08-10-027) to ensure continuity of viable 2006-2008 programs through 2009. The Commission also authorized that the 2006-2008 RRIM be extended into the 2009 bridge year in D.10-12-049.[5]

Prospective RRIM reform proposals were addressed in the April 1, 2009, Energy Division "White Paper on Proposed Energy Efficiency Risk-Reward Incentive Mechanism and [Evaluation, Measurement, and Verification] EM&V Activities." (White Paper.)[6] By ruling issued April 16, 2009, the White Paper was incorporated into the record in R.09-01-019. On April 29, 2009, parties filed comments on the White Paper, with reply comments on May 11, 2009.

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[5] The original intent was to adopt a 2009-2011 energy efficiency budget cycle. Due to various factors, including adoption of the Strategic Plan and the need for significant revisions to the utility portfolio applications, the budget cycle start was deferred one year. Bridge funding was authorized in D.08-10-027 to ensure that viable programs continued through 2009.

[6] The White Paper was served jointly on parties in this proceeding and in Application (A.) 08-07-021 et. al. (applications regarding 2009-2011 EE Programs).

On May 22, 2009, parties filed initial proposals for prospective RRIM reforms, with responses filed June 12, 2009. A workshop was convened on July 15, 2009, to address the proposals. Post-workshop comments filed on August 7, 2009, incorporated further amendments.[7]

On November 15, 2010, the assigned Administrative Law Judge (ALJ) issued a Proposed Decision (PD) for RRIM reforms to apply for the 2010-2012 cycle. The PD incorporated various changes from the previously adopted RRIM, and called for the use of ex ante parameters to calculate a new shared savings formula. The PD remained unresolved, among other reasons, because of continuing uncertainty regarding ex ante parameters supporting the 2010-2012 portfolio. The PD was ultimately withdrawn.

Protracted disputes in R.09-11-014 [8] were finally resolved in July 2011 regarding ex ante values for 2010-2012 programs. Once the outstanding disputes regarding ex ante values for the 2010-2012 cycle were resolved, the assigned Commissioner issued a ruling on August 30, 2011 to refresh the record on RRIM issues.[9] Comments on the ruling were filed on September 23, 2011, and reply

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[7] Between September 2009 and November 2010, the focus of R.09-01-019 proceedings was on RRIM issues applicable to earnings claims for the 2006-2008 program cycle.

[8] On November 25, 2009, R.09-11-014 was opened to address the policies, programs and evaluation, measurement and verification activities related to the post-2008 energy efficiency activities. As the successor to R.06-04-010 (post-2005 rulemaking on Policies, Programs, Evaluation, Measurement and Verification, and Related Issues), R.09-11-014 sought to address updates to EE savings goals.

[9] Commission John Bohn was originally the assigned Commissioner in R.09-01-019. On January 11, 2011, Commissioner Michael R. Peevey became the assigned Commissioner in R.09-01-019. On April 13, 2011, Commissioner Mark J. Ferron became the assigned Commissioner in R. 09-01-019, and continued as the assigned Commissioner in the successor proceeding, R.12-01-005.

comments were filed on October 7, 2011. Upon review of comments, the Commissioner issued a follow-up ruling on December 16, 2011.

On January 12, 2012, the Commission opened Order Instituting Rulemaking (OIR) 12-01-005 (successor to R.09-01-019 which, in turn, was successor to R.06-04-010, our inquiry into post-2005 energy efficiency policies, programs, evaluation, measurement and verification, and related issues).[10] Comments on the OIR were filed on February 2, 2012, incorporating comments on the December 16, 2011 ruling issued in R.09-01-019. Parties filed reply comments on the OIR on February 16, 2012. Prehearing Conference (PHC) Statements were filed March 19, 2012. A PHC was held on March 23, 2012, and a scoping memo was on May 16, 2012. The scoping memo determined that no further comments would be filed relating to the 2010-2012 program cycle. The record underlying this decision thus incorporates relevant filings in R.09-01-019, as well as filings submitted in R.12-01-005.

On August 22, 2012, the assigned Commissioner and ALJ issued an amended scoping memo. That scoping memo alerted parties that the Commission intended to consider 2010-2012 reforms, if any, in Q4 2012. It also indicated that if the Commission were to approve an incentive mechanism, such a payment would occur in the same decision rather than in a separate proceeding. The August 22, 2012 Scoping Memo also entered into the record public versions of the Commission's Utility Audit, Finance and Compliance Branch reports, which examined the 2010 Energy Efficiency Programs for each of

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[10] In R.06-04-010, among other things, the Commission set energy efficiency goals (e.g., D.08-07-047) and designed an incentive mechanism to promote energy efficiency.

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the utilities. On September 25, 2012, the ALJ issued a ruling outlining a proposal for a new incentive mechanism and also entered into the record performance findings based on 2010 activities.

3. Factual and Policy Background

Culminating an extended history of applying various forms of incentives seeking to maximize energy efficiency savings, in September 2007, the Commission adopted the RRIM in D.07-09-043. As noted in the Energy Action Plan[11] and past Commission decisions, there is an inherent utility bias towards supply-side procurement under cost-of-service regulation. Investor-owned utilities generate earnings when they invest in supply-side resources, but not when implementing cost-effective energy efficiency measures.

The RRIM was devised to address the utility bias in favor of supply-side resources by providing the opportunity for incentive earnings on par with investment opportunities from supply-side resources. RRIM earnings were determined as a share of cost savings from Commission-approved energy efficiency measures. The incentive formula applied: (a) a minimum performance standard (MPS) and (b) a performance earning basis (PEB). For savings from 85% to 100% of MPS goals, the utility earned 9% of the PEB. For

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R.09-01-019 addressed reforms to the incentive mechanism for energy efficiency programs.

[11] California's principal energy agencies, including this Commission, joined to create the Energy Action Plan in 2003. This plan identifies specific goals and actions to ensure that adequate, reliable and reasonably-priced electrical power and natural gas supplies are achieved and provided through cost-effective and environmentally sound strategies.

savings achieved greater than 100% of MPS goals, a 12% shared savings rate applied.[12] Any remaining savings flowed back to ratepayers.

For the 2006-2008 cycle, the Commission provided annual incentive payments, with two interim installments and a third final installment. As early as the first installment awarded in December 2008, the Commission recognized that the RRIM was not functioning as intended. The Commission adopted limited modifications to the RRIM in conjunction with approving the first two installments of incentive payments for 2006-2008.

In D.10-12-049, the Commission modified the RRIM more significantly for the third installment. The RRIM had originally been designed to base the third installment payment on an ex post evaluation and update. Among other things, D.10-12-049 modified the mechanism to use ex ante estimates,[13] rather than ex post evaluations, for the final 2006-2008 RRIM installment. In D.10-12-049, the Commission also authorized one additional installment of incentives for the single bridge year of 2009, also based on ex ante values.

The Commission adopted these modifications in view of controversies over the ex post evaluations of net benefits, including the updates to the Database of Energy Efficiency Resources (DEER)[14] utilized to evaluate net

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[12] Savings between 65% and 84% were to be in a "deadband" range where no rewards or penalties applied. Savings below 65% subjected the utilities to penalties. Maximum limits on incentive earnings and penalties were capped at $450 million for 2006-2008.

[13] Ex ante refers to energy savings associated with an energy efficiency measure or equipment based on estimates prior to installation. Ex ante values are used to determine whether a forecasted energy efficiency portfolio is cost-effective. (*See* D.05-04-051 at 35.)

[14] The DEER holds the collective savings assumptions applied in planning and updated through evaluation, and is periodically updated to ensure the most accurate estimates

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benefits. Ex post evaluations were particularly controversial as they involved assumptions that could be difficult to verify, and differences between ex ante and ex post values impacted incentive earnings significantly.

For the 2006-2008 true up and 2009 bridge year awards, the Commission reduced the shared savings rate to 7% (down from the 9%/12% rates adopted in D.07-09-043). The 7% rate was to reflect an assessment of reduced shareholder risk associated with reliance on ex ante values with no ex post true up.

In November 2010, the assigned ALJ in R.09-01-019 issued a PD for a revised mechanism for the 2010-2012 cycle to determine incentives based on ex ante values used in developing the 2010-2012 portfolio, and with an ex post true up limited to verified installations and audited administrative costs.[15]

Since the EE programs for 2010-2012 programs differed significantly from the 2006-2008 portfolios, however, the PD sought to revise the RRIM shared savings formulas to be consistent with the new programs. The RRIM shared savings rates previously used were predicated upon 2006-2009 programs. To the extent that 2010-2012 programs reflected changes in costs, load impacts and investor risk, the previous RRIM earnings cap and shared savings rates would no longer be relevant. Accordingly, the PD sought to develop revised shared savings rates based upon ex ante data for the 2010-2012 cycle. At the time that

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of actual load impacts resulting from ratepayer investments in energy efficiency. For the 2010-2012 cycle, the Commission utilized DEER 2008 values (as referred to in D.09-09-047).

[15] The PD also incorporated other reforms such as elimination of the tiered MPS for incentive payments. Originally, the IOU was at risk for no incentive earnings (or penalties) for performance below a tiered MPS threshold. The tiered structure created a potential "cliff" effect whereby small changes could result in large differences in RRIM rewards or penalties.

the ALJ's PD was issued, however, significant uncertainty remained regarding ex ante values for the 2010-2012 cycle.

We approved EE budgets for the 2010-2012 cycle in September 2009, in D.09-09-047. We expressed the intention to freeze ex ante assumptions used to develop the 2010-2012 portfolio for tracking savings against goals, contingent on compliance and consistency in utility data. We committed to streamlining EM&V efforts with the goal of increasing their usefulness while lessening the contentiousness witnessed during the 2006-2008 cycle. Nonetheless, ex ante values supporting the underlying programs were not finalized until July 2011, with over two-thirds of the cycle completed.

In view of the delays in finalizing relevant data for the 2010-2012 programs, and related controversies, however, a timely recalculation of shared savings rates incorporating ex ante values for the 2010-2012 cycle was not completed. The PD attempted a calculation of shared savings rate, but based only on preliminary estimated assumptions. In view of these uncertainties and other contentious issues, the PD on RRIM reforms for 2010-2012 was never adopted. The PD was subsequently withdrawn from Commission consideration.

Various parties had argued that relying on ex ante values for calculating 2010-2012 incentive earnings could avoid the delays and controversies previously encountered with ex post evaluations. Based on our experience so far with the 2010-2012 cycle, however, we now appreciate that ex ante values can be just as contentious as ex post evaluations. Attempting to shift the focus from an ex post to an ex ante does not expedite or simplify the determination of relevant metrics for a 2010-2012 RRIM, but only moved the debate from the back end (with ex post evaluations) to the front end of cycle (where ex ante values are determined.

We briefly note some of the factors that delayed finalizing 2010-2012 ex ante values. A March 31, 2010 deadline had originally been set for all ex ante estimates for 2010-2012 to be frozen.[16] The deadline was not met.

To obtain a complete data base of ex ante values for 2010-2012, the Commission assigned the Energy Division with the task of developing a process to review and approve: (1) updates to the DEER; (2) non-DEER workpapers; and (3) customized projects. Due to various factors, controversy led to protracted delays.

As noted in D.09-09-047, the Commission expected Energy Division to use the best available information to update the 2008 DEER after consulting with the utilities on possible updates (including errors). Yet, there was no procedural vehicle for Energy Division to finalize modifications to the 2008 DEER. The utilities, moreover, did not accept the outcomes determined by Energy Division.

When the Commission initially approved the 2010-2012 budgets in September 2009, Energy Division had not yet performed a review and approval of the IOUs' non-DEER-measure ex ante estimates. (D.09-09-047 at 302.) Energy Division rejected or required major changes to the non-DEER measure workpapers.

Further controversy arose when the Joint Utilities filed a Petition for Modification of D.09-09-047 on September 17, 2010. The Petition stated:

> After much discussion and collaboration between the Joint IOUs and Energy Division and its consultants, the energy savings assumptions have not yet been frozen, despite this Commission objective. The result is that nine months into the

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[16] *See* ALJ's Ruling in A.08-07-021 et al, Regarding Non-DEER Measure *Ex Ante* Values, dated November 18, 2009, at 4.

> program cycle, the energy savings assumptions continue to represent a "moving target" for the Joint IOUs. The Joint IOUs and the Energy Division agree the process is currently at a stalemate and that direction from the Commission is needed to move forward.

Final determination of 2010-2012 ex ante values was delayed in order to resolve the Petition. Ex ante disputes for DEER measudrares were finally resolved in D.10-12-054. The Commission adopted non-DEER ex ante measures in D.11-07-030. As a result, the data required to calculate updated incentive mechanism formulas for the 2010-2012 cycle was not available before July 2011 (over half way through the cycle).

The assigned Commissioner issued a ruling dated August 30, 2011, directing the IOUs to calculate revised RRIM shared-savings percentage calculations based on the adopted ex ante data for 2010-2012. The assigned Commissioner issued a subsequent ruling on December 16, 2011, renewing the directive for the updated calculations. On February 2, 2012, the IOUs provided calculations of shared savings rates based on 2010-2012 ex ante assumptions. The protracted controversy surrounding ex ante values thus resulted in corresponding impediments in calculating and evaluating possible RRIM revisions.

4. Parties' Positions Regarding a 2010-2012 Incentive Mechanism

Over the course of consideration of prospective reforms in the RRIM, parties' proposals and positions have evolved. We focus on parties' final positions regarding a 2010-2012 incentive mechanism, rather than summarizing the entire history of past proposals, some of which are outdated with the passage of time.

4.1. PG&E's Position

PG&E argues that an incentive mechanism should be approved for the 2010-2012 cycle in order to preserve consistency of the Commission's regulatory treatment. PG&E asserts that by providing for an incentive mechanism for the 2010-2012 cycle, the Commission will create continued regulatory certainty, so that the IOUs and investors will be motivated to fully invest in a long term aggressive EE program that will help meet California EE policy goals.

PG&E recommends that the Commission adopt an incentive mechanism for the 2010-2012 cycle largely based on the mechanism use to award incentive earnings for the 2009 bridge year.[17] PG&E claims it has been executing portfolio programs throughout the 2010-2012 cycle based on the assumption that each utility would be awarded incentives for 2010-2012 activity based on the RRIM formulas applied for 2009 bridge year.

For 2010-2012 incentive payments, PG&E proposes the use of the ex ante savings assumptions as adopted in D.09-09-047 and in D.11-07-030. PG&E also proposes: (1) applying the Custom Measure Review Process Gross Realization Rate for all non-reviewed custom projects; (2) using the workpaper values approved in D.11-07-030; (3) using the values approved in the Phase 2 workpaper approval process; and (4) using installation rates provided by the IOUs in response to a directive in D.11-07-030.

PG&E proposes that the minimum performance standard be calculated using cumulative savings beginning in 2010, as suggested by Energy Division

[17] *See* D.11-12-036 for further detail on the incentive earnings given for 2009 bridge year activities.

Staff for the 2013-2014 portfolio goals. (The Commission study on cumulative savings methodology has not yet been completed.)

PG&E calculates, as provided in its February 2, 2012 analysis, that for the 2010-2012 cycle, a shared savings rate of 43.2 % would yield incentive earnings approaching the return that could be earned on corresponding supply side-investments. PG&E, however does not to seek approval of a 43.2% shareholder earnings rate for the 2010-2012 cycle. PG&E proposes only a 7% shared savings rate for the 2010-2012 cycle, as was previously applied for the 2006-2008 RRIM true up and 2009 bridge year. PG&E argues that applying the same rate for 2010-2012 would allow for a timely and reasonable award for portfolio achievements.

4.2. Joint Utilities' Position

The Joint Utilities (i.e, SDG&E and SoCal Gas) submitted a proposal as outlined below for purposes of determining incentives for the 2010-2012 cycle. They however, would agree to essentially use the same formulas used for the 2009 bridge year, given the limited remaining time in the 2010-2012 cycle, and recognizing resource constraints in simultaneously preparing 2010-2012 claims together with the 2013-2014 portfolio applications.

The Joint Utilities' preferred proposal for 2010-2012 is for an incentive formula utilizing the elements as follows:

- There would be an elimination of reliance on goals and minimum performance standard for purposes of the RRIM. Rewards would simply be based on a single percentage of 7% of the net benefits of energy savings.
- Ex ante data frozen before the earnings period would be used to determine savings achievements.
- Ex post verification would be limited to installations and expenditures to determine the final PEB.

- EM&V ex post study results would be used to determine ex ante values in the next cycle.
- The PEB net expected benefits calculation would continue to equal 2/3 of the Total Resource Cost and 1/3 the Program Administrator Cost.
- Non-resource programs including market transformation programs would be excluded from the calculation of the RRIM.
- Resource programs with net-to-gross ratios greater than 20% would be allowed.
- For purposes of the RRIM only, custom projects submitted after publication of D.11-07-030 would use 75% of engineering estimates of savings to determine PEB with no additional adjustments from the net-to-gross ratio. Custom measures submitted prior to D.11-07-030 would use the default of 90% of engineering estimates of savings for determining the PEB with no additional adjustments from the net-to-gross ratio.
- Annual recovery holdback of 25% subject to completed verification of installations and costs, to be completed prior to the next year's earnings assessment.
- Cap on earnings of RRIM would be utility-specific and equal to 1.5 times the overall EE program expected PEB.

4.3. SCE's Position

SCE does not advocate adoption of any incentive mechanism for the 2010-2012 cycle. SCE believes that because any Commission decision on a RRIM for the 2010-2012 cycle would be issued well into 2012, any adopted mechanism would provide a weakened incentive signal with respect to construction and execution of the 2010-2012 portfolio. SCE states that everyone's collective time and efforts would be best spent looking ahead to the development and implementation of a new mechanism that is aligned with program designs for

2013-2014 and beyond. SCE believes that the Commission should focus its efforts on devising an effective 2013-2014 mechanism.

SCE proposes a transition away from a shared savings mechanism grounded in estimations, calculations and conclusions drawn from subjective studies. SCE supports what it calls a simpler, more straight-forward mechanism that rewards implementation of the portfolio approved by the Commission.

In compliance with the Assigned Commissioner's Ruling, SCE calculated that a shared savings rate of 77% for the 2010-2012 cycle (based on supply-side equivalent earnings total $510 million, divided by $664 million PEB). SCE states, however, this derived shared savings rate for the 2010-2012 cycle is not a palpable basis for an incentive mechanism. SCE states that while comparability to supply-side investments does provide an appropriate benchmark, it must be reasonable. A shared savings rate is intended to determine the percentage in which IOU shareholders and ratepayers share in the resource benefits created by energy efficiency. SCE does not believe it is reasonable to give shareholders nearly two-thirds of those benefits. SCE believes the derived shared savings rate of 77% may demonstrate that a shared savings approach is not the appropriate means to achieve the Commission's policies in a manner consistent with the Energy Action Plan.

4.4. NRDC's Position

NRDC supports the adoption of a RRIM for 2010-2012 as an important policy tool to promote EE goals. NRDC proposes to continue the basic structure of the 2006-08 RRIM for the 2010-2012 cycle with the following modifications to simplify the mechanism:[18]

- A single shared savings rate of 8% to 10%;
- Use of ex ante values, except for ex post updates to installations and program costs;
- Minimum Performance Standard (MPS) when portfolio is cost-effective instead of tied to goals;
- No per-unit penalties, but "cost-effectiveness guarantee" penalty remains; and
- Performance Earnings Basis excludes "non-resource" program costs, with consideration of a separate mechanism for non-resource programs held to a later phase of the proceeding.

NRDC previously provided a calculation for adjusting the RRIM to account for the differences in the 2006-2008 versus 2010-12 portfolios and other changes in the RRIM. NRDC believes that, weighing all anticipated changes in the RRIM, the 2010-12 expected earnings should be approximately the same or moderately lower than the expected earnings for 2006-08 approved in D.07-09-043 (based on a range of $323 million at 100% of goals up to $450 million at the cap). NRDC thus proposes a shared savings rate for 2010-2012 in the range

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[18] Many of these elements are similar to those proposed by the Sempra Utilities (at 6). *See* NRDC, *Comments of the Natural Resources Defense Council (NRDC) on the Proposed Decision Regarding Risk/Reward Incentive Mechanism Reforms*, R. 09-01-019, at 9 (December 2010); NRDC, *NRDC Reply Comments on the Proposed Decision Regarding the Risk/Reward Incentive Mechanism Earnings True-Up For 2006-2008*, (October 2010).

of 8% to 10%, reflecting a level of earnings of approximately 1% of estimated utility profits.

If the Commission decides to simply extend the 2009 mechanism into 2010-2012, however, NRDC recommends that the Commission extend the 2009 mechanism "as is" (i.e. using the 7% shared savings rate and other 2009 parameters) without taking further comments on adjustments. NRDC believes that the primary rationale for adopting such an extension would be its simplicity and the ability to adopt it readily.

NRDC agrees with TURN on the primary risk factors that warrant a reduction in potential earnings, but disagrees on the magnitude of the reduction. NRDC agrees that the use of ex ante values for most metrics reduces the utilities' risk and warrants a reduction in incentive earnings opportunity. NRDC, however, still supports an EM&V process that produces reliable results that can be updated in a timely manner.

However, NRDC disagrees with TURN's assertions that the risk adjustment for the change from ex post to ex ante metrics should result in a 55% earnings reduction. The 55% figure is based on the ratio of Energy Division's proposed ex post values for 2006-08 relative to the ex ante values. TURN bases its proposal on the ratio of Energy Division's proposed ex-post values for 2006-08 relative to the ex-ante values. NRDC disagrees with this approach because Energy Division's proposed ex-post values were not adopted by the Commission.

4.5. DRA's Position

DRA recommends that the RRIM be entirely eliminated, with no further resources devoted to possible alternatives that involve payment of shareholder earnings. DRA claims there is a fundamental disconnect between the IOUs' role in procuring supply-side resources and the energy efficiency goals of reduced consumption. DRA argues that there is no correlation between incentive earnings and performance of utility-run EE programs.

DRA argues that there is an inherent contradiction in values between energy efficiency and utilities' fiduciary investment responsibility. DRA claims that the IOUs have not demonstrated the ability to adapt to changing market conditions, yet expertise with market transformation is crucial to the future success of EE.

DRA questions the validity of offering shareholder incentives for utility administration of energy efficiency, especially when no incentives are authorized for other programs that reduce demand, including demand response programs, the California Solar Initiative, or other distributed generation programs.

DRA claims that despite years of various incentive mechanisms, the IOUs have engaged in over procurement of supply-side resources and underachievement of energy savings while challenging independent evaluations of their energy savings achievements. As a result, DRA claims that ratepayers have been forced to fund underperforming EE investments, including the payment of incentives, while also funding higher supply-side costs.

DRA claims that PG&E, SCE and SDG&E neglected to incorporate EE programs into their long-term procurement plans to the full extent of Commission adopted goals and the California Energy Commission's (CEC) translation of those goals into energy efficiency forecasts to reduce procurement requirements.

4.6. WEM's Position

WEM also opposes any further incentive program that pays shareholder earnings. WEM argues that the RRIM fails to provide any incentive for achieving EE. WEM believes that RRIM works against better EE programs, and that EM&V, as developed for the purpose of calculating RRIM earnings, is largely useless for determining the grid-reliability of EE. WEM compiled a chart reflecting the CPUC Planning Assumptions for the Long-Term Procurement Plans, to show system wide surpluses of 150% this year, and 156% in 2020.

WEM claims that the time lag is excessive between when a measure is installed versus when EM&V is performed, with a delay of as many as three or four years after an EE measure is installed. WEM argues, for example, that earnings are awarded at a time when many compact fluorescent lamps funded by the programs have already burned out. WEM complains that EM&V provides hardly any reports on the distribution of energy savings in relation to the needs of procurement and transmission/distribution planning.

4.7. TURN's Position

TURN believes there is no theoretical or practical basis for basing EE shareholder incentives on avoided supply side investments. TURN argues that a more effective and efficient method for promoting EE programs would be to adopt an independent administrator(s) model. TURN's preferred solution is the creation of a competitive environment for alternative effective and efficient energy efficiency services outside of the utility.

If, however, the Commission chooses to provide incentives to IOUs, TURN believes that a management fee model would be superior to a shared savings model. Rather than providing separate "shareholder incentives" for energy efficiency, TURN argues that the utilities should include energy efficiency goals in their employee bonus programs (for example, the "results sharing" programs which provides bonuses based on a variety of performance measures), and to provide a reasonable management fee-type shareholder incentive for utility performance, analogous to incentive mechanisms adopted for safety, reliability and customer service.

A 'shared savings' model assumes that the utilities could become indifferent as between supply and demand. TURN argues, however, that even the utilities themselves have generally agreed that the fundamental purpose of incentives for energy efficiency is not to change fundamental corporate goals. Rather, the incentives were a tool to make a certain activity sufficiently profitable so that management would focus attention and resources on that department.

TURN argues that if the Commission chooses to apply the shared savings incentive model for the 2010-2012 cycle, the percentage of savings assigned to investors should be reduced to reflect the lower risk inherent in modifications to the mechanism that was originally adopted in D.07-09-043. TURN concluded that removing the risk of using ex post values to calculate savings, as originally required, results in a risk adjustment of at least 55%. TURN calculated that this risk reduction translated into an illustrative sharing rate of 6.2% based on the preliminary estimates of 2010-2012 results provided in NRDC's filings. In order to account for additional reduced risk as a result of no per-unit penalties and no claw-back of overpayments, TURN believes the sharing rate should be reduced to 5%.

5. Discussion

In determining whether to devote further resources toward designing and implementing an incentive mechanism for the 2010-2012 cycle, our guiding concern is whether we advance our goals of promoting Commission EE policy objectives. Spending further time and effort dealing with incentive controversies for the 2010-2012 cycle would not advance those goals or objectives. Therefore, we decline to adopt an incentive mechanism for the 2010-2012 cycle.

The effectiveness of an incentive mechanism depends on the timing of its adoption and implementation. As observed in D.10-12-049, any incentive, to be effective, should be designed based upon the goals, benchmarks and performance parameters in effect at the start of the program cycle. For 2010-2012, as discussed previously, the relevant parameters of any incentive mechanism were not known until well into the cycle.

With the 2010-2012 cycle now nearly complete, any incentive mechanism would have no material effect on the design or execution of 2010-2012 programs. Moreover, considerable controversy remains over whether, and if so, how an incentive mechanism should be designed and applied to the 2010-2012 cycle to offer meaningful incentives to meet or exceed Commission goals and objectives. For example, questions remain regarding the effectiveness of a shared savings model in avoiding or deferring supply-side investments.

Disputes regarding the proper integration of EE programs and resource planning assumptions have not been fully explored for purposes of adopting a 2010-2012 RRIM. Moreover, some of the concerns over long term resource planning may be more appropriately addressed in (or coordinated with) other proceedings dealing with long term resource procurement.

We also believe that questions as to the appropriate form of incentives (e.g., use of shared savings versus management fees, etc.) have not been adequately explored. Since we decline to adopt a mechanism for 2010-2012, we need not address in detail the merits of all proposed revisions in RRIM design for the 2010-2012 cycle. We expect to address such issues further in the context of the 2013-2014 cycle.

In addition to the time that would be required to devise a 2010-2012 incentive mechanism, additional time would be needed to review and process actual claims for RRIM earnings. For 2009 RRIM claims approved in D.11-12-036, applications were filed in June 2011. Assuming a first installment of a 2010-2012 claim covering calendar years 2010 and 2011, the work to review and process such claims would extend beyond calendar year 2012. RRIM claims covering 2012 programs would require yet more resources.

By not diverting further resources to devise a backward-looking incentive mechanism, however, we can devote full priority to devising effective forward-looking incentive programs the 2013-2014 cycle. We thereby provide the greatest opportunity to maximize energy efficiency goals by developing a meaningful incentive program.

We recognize, as previously discussed in D.08-01-042, to be effective in motivating pursuit of energy efficiency goals, incentive earnings should be used as a basis for the IOUs' financial valuation. The IOUs must be able to book incentive earnings on a regular basis in a manner that can be anticipated by the investment community. Otherwise, as previously noted, earnings from energy efficiency programs would not be truly on par with earnings from supply-side resources in the minds of investors.

Incentive earnings that are not booked at regular intervals would result in a one-time adjustment and likely be excluded from earnings used as the basis for utility financial valuation. This uncertainty could result in a higher cost of utility financing. As a consequence, the full potential benefit of shareholder incentives would not be realized.

While our original expectation was to provide an opportunity to earn ongoing annual incentive awards, that expectation was premised on an effectively working mechanism. Perpetuating the previous mechanism through the 2010-2012 cycle simply for the sake a continuous flow of annual earnings serves no valid Commission goal or public purpose in advancing energy efficiency goals. Rather than attempting to cobble together a backward-looking mechanism for the 2010-2012 cycle, the superior choice is to focus on design of an effective mechanism for 2013-2014.

By affirming a commitment to meaningful incentive reform for the 2013-2014 cycle, we send the message to the IOUs and the investment community that implementing an effective and timely incentive mechanism remains a high priority. An effectively designed forward-looking mechanism for 2013-2014 offers the best prospect for offering ongoing regular incentive earnings opportunities. Diverting further resources to devise and implement a backward-looking 2010-2012 mechanism, however, would only increase the uncertainty that an effective mechanism could be put in place by early 2013.

Based on our commitment to adopt effective incentive reforms by early 2013 to provide for regular ongoing earnings on a forward basis, we are confident that the IOUs will be motivated to treat EE programs as a core part of the utility operations.

We are not persuaded that the IOUs are entitled to 2010-2012 incentive awards based on claims that they have executed programs under the belief that they would ultimately qualify for incentive earnings. In setting the scope of the proceeding, and its predecessor R.09-01-019, the Commission defined broadly the scope of possible changes in incentive program design that could apply subsequent to the 2006-2008 cycle (as extended to include 2009 as a bridge year). The nature and extent of any revised incentive program subsequent to 2009 has remained unresolved until now.

While authorizing the IOUs to file for RRIM awards for the 2009 bridge year in D.10-12-049, the Commission adopted no subsequent determinations as to what, if any, incentive design might apply for 2010-2012 programs. In D.11-12-036, the Commission affirmatively stated:

> ... subsequent RRIM design for the 2010-2012 program cycle or beyond has not been determined by the Commission. That topic is the subject in R.09-01-019 and our actions today should not be considered to extend beyond these applications. (D.11-12-036 at 10.)

Although the assigned ALJ previously issued a PD for incentive reform to apply for the 2010-2012 cycle, as discussed previously, the PD was withdrawn. Thus, no explicit incentive mechanism has been in place to influence 2010-2012 EE program results. In fact, since a PD was withdrawn that could even indicate to the parties that the Commission could not reconcile this matter, which in turn makes an inference of certainty that much more suspect. Ultimately, only Commission action should carry weight. The IOUs had no foreknowledge of future Commission action regarding how (or whether) a RRIM might be designed or implemented for 2010-2012.

We have no basis to speculate whether savings goals would have been met or exceeded differently assuming some sort of incentive mechanism had been in place, at the start of the cycle. May issues remain unresolved concerning what adjustments would yield incentive earnings on par with supply-side resources to produce and deliver units of energy and demand avoided by energy efficiency programs. Based on the IOUs' calculations, very high shared savings rates would be necessary to provide earnings on par with supply-side options. No party claims that the IOU calculations of those high shared savings rates would provide a fair share of net benefits to ratepayers.

Whatever shared savings rate might be appropriate for 2010-2012 would have to be consistent with the previously stated rationale to offer earnings from EE investments to be on par with earnings from corresponding supply-side resources. Among the proposals presented, we find no convincing basis for an appropriate shared savings rate that would motivate an IOU to forego investments in supply-side resources while protecting ratepayers' interests.

PG&E and the Joint Utilities propose a 7% shared savings rate essentially as a pragmatic default, claiming it is less controversial and can be readily adopted. We are not persuaded by the rationale to adopt such a rate. Although certain parties claim that a 7% rate would be expedient and less controversial, the 7% rate is not supported by all parties. DRA, TURN, and WEM, in particular, oppose a 7% shared savings rate. SCE takes the position that adopting any particular shared savings rate is problematic. SCE offers no incentive mechanism proposal for the 2010-2012 cycle. Thus, adopting a 7% rate would not eliminate or resolve disputes concerning whether a shared savings mechanism should be adopted for 2010-2012, and if so, what rate should apply.

The 2010-2012 portfolio is based on very different assumptions and conditions. Although we applied a 7% shared savings rate for 2006-2008 and 2009, there is no good reason to assume that a 7% rate is appropriate for 2010-2012 as well. The assumptions and rationale underlying the 7% rate were based on the 2006-2008 and the 2009 bridge year portfolios.

As noted above, NRDC proposes a somewhat higher shared savings rate of 8% to 10%. Although NRDC attempted to provide an updated shared savings calculation for 2010-2012, the NRDC calculations were preliminary, and did not incorporate actual ex ante values finally adopted by the Commission.

Adopting a 2010-2012 shared savings mechanism would also fail as an incentive without an appropriate level of risk-adjusted earnings opportunities, while protecting ratepayers' interests. Establishing appropriate parameters for risk-adjusted earnings on a shareholder incentive mechanism is ultimately a matter of judgment, and not a precise science. Nonetheless, informed judgment requires careful deliberation of the relevant facts and policies involved. Certain parties attempt to quantify adjustments for reduced risks associated with a revised mechanism. Others decline to offer any risk adjustment analysis at all. Since we have determined not to adopt a mechanism for 2010-2012, however, we need not attempt to devise an earnings adjustment for risk.

We are not persuaded that any of the incentive earnings proposals are appropriately designed to motivate management to view EE programs as a core part of utility regulated operations. Based on the IOUs' own calculations, an unacceptably high shared-savings rate would be needed to approximate earnings from supply-side resources.[19] We likewise find insufficient empirical support to determine whether the NRDC savings rate of 8%-10% offers an appropriate value, particularly in view of the shared savings rates calculated by the IOUs.

During the 2006-2008 cycle, the IOUs argued that incentive earnings should not be based upon changes in parameters that become known only after the program cycle begins. For the 2010-2012 cycle, ex ante parameters remained uncertain as late as July 2011. Assuming a mechanism was to be based on ex ante values finalized as late as July 2011, incentive payments would not be based on parameters known at the beginning of the cycle. Yet, if different ex ante values were used, ratepayers may have no assurance that incentive payments would be based on cost effective assumptions.

We are left with the conclusion that at least for the 2010-2012 cycle, a shared savings model does not offer an effective solution for an incentive mechanism. Likewise, at this late date, it would serve no useful purpose to devise a different sort of incentive model for a cycle that is now largely concluded. We thus decline to address further the design of an incentive mechanism for 2010-2012. We look forward to addressing 2013-2014 incentive reform issues in a subsequent decision.

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[19] The calculations provided February 2, 20102, by the IOUs of shared savings rates for 2010-2012 necessary to produce incentive earnings on par with corresponding supply-side investments were as follows: PG&E: 43.2%' SCE 77%; for SDG&E: 28%-35%; and for SoCalGas, 24%.

6. Comments on Proposed Decision

The proposed decision in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3. Comments were filed on December 4, 2012, and reply comments were filed on December 10, 2012 by various parties. No revisions are made in response to comments.

7. Assignment of Proceeding

Mark J. Ferron is the assigned Commissioner and Thomas R. Pulsifer is the Presiding Officer in this proceeding.

Findings of Fact

1. The Commission adopted shareholder incentives in D.07-09-043 so that energy efficiency programs will be pursued vigorously by utility management as a core business strategy.

2. Implementation of RRIM has become a diversion consuming valuable and limited time and resources.

3. The Commission had concluded the awarding of incentive earnings for the 2006-2008 cycle and for the 2009 bridge year.

4. The Commission has not adopted any incentive mechanism for the 2010-2012 budget cycle.

5. A Proposed Decision was previously prepared which attempted to devise incentive mechanism reforms for the 2010-2012 cycle.

6. The PD for a revised mechanism for the 2010-2012 cycle sought to determine incentives based on ex ante values used in developing the 2010-2012 portfolio, and with an ex post true up limited to verified installations and audited administrative costs.

7. In view of the uncertainties and delays relating to ex ante values and other contentious issues, the PD on RRIM reforms for 2010-2012 was never adopted, but was subsequently withdrawn from Commission consideration.

8. Attempting to shift from an ex post to an ex ante focus did not expedite or simplify the determination of relevant metrics for a 2010-2012 RRIM, but only moved the debate from the back end (with ex post evaluations) to the front end of cycle (where ex ante values are determined).

9. Although the Commission expressed the intention in September 2009, to freeze ex ante assumptions used to develop the 2010-2012 portfolio for tracking savings against goals, contingent on compliance and consistency in utility data, controversies precluded finalization of the ex ante values until July 2011.

10. Since the 2010-2012 cycle is nearing its conclusion, any adopted incentive mechanism applied to the 2010-2012 portfolio would have no material influence on the nature, extent, or success of utility action to achieve EE savings, either during the 2010-2012 budget cycle or for the 2013-2014 cycle.

11. There is no basis for findings as to how successful the IOUs may have been in meeting savings goals, or whether savings goals would have been met or exceeded differently assuming some sort of incentive mechanism had been in place, or assuming the IOUs expected some sort of incentive awards for 2010-2012.

12. A number of disputes remain unresolved regarding whether, and if so, how, an incentive mechanism should be designed and implemented for the 2010-2012 cycle.

13. Significant controversy remains over what, if any, shared savings rate should apply for the 2010-2012 cycle. There is no consensus for the adoption of a 7% shared savings rate.

14. Allocating additional time and resources to the devising an incentive mechanism for the 2010-2012 cycle, and adjudicating related claims for payment of awards would divert resources from the priority goal of developing and implementing effective prospective incentive policies early in the 2013-2014 cycle.

15. A forward-looking focus on devising effective incentive programs for the 2013-2014 period will provide the greatest opportunity to advance policy goals to maximize energy efficiency through the use of incentives.

16. Evaluated ex post updates have been controversial particularly because they impact the magnitude of incentive earnings so significantly. Ex post updates often involve metrics whose measurement requires considerable subjective judgment and debates as to the meaning and use of raw data.

17. In D.09-09-047, the Commission both 2008 DEER and non-DEER ex ante measure values as of the beginning of the 2010-2012 cycle for purposes of establishing savings goals and portfolio performance over the 2010-2012 program cycle.

18. Without an effective energy efficiency incentive, given the focus of investors and utility management on increasing shareholder value, utilities will on balance be more inclined to devote scarce resources to procurements on which they will earn a return, rather than on meeting or exceeding the Commission's energy efficiency goals, or maximizing ratepayer net benefits in the process.

19. The RRIM earnings rates, and the cap, as previously adopted, were based upon assumed conditions attributable to the 2006-2008 portfolio of measures in comparison to earnings on supply-side.

20. There is a trade-off between risk and the magnitude of earnings to provide a reasonable incentive to pursue energy efficiency investments as a core business activity. The precise quantification cannot be reduced to a precise mechanical formula, but requires reasoned judgment based on an analysis of relevant data.

Conclusions of Law

1. Pursuant to relevant statute, and past Commission policy directives, energy efficiency programs should be prioritized as the first resource to meet California's energy demand. Any directives regarding incentive policy should be consistent with California's commitment to making EE the highest energy resource priority.

2. The Commission has not previously issued any affirmative determinations as to whether an incentive mechanism would apply for the 2010-2012 cycle.

3. A decision not to divert further resources to devise and administer an incentive mechanism applicable to the 2010-2012 cycle is consistent with the Commission's goal to adopt timely prospective incentive reforms early in the 2013-2014 cycle.

4. No further resources should be devoted to devising an incentive mechanism to apply to the 2010-2012 cycle.

5. Since no mechanism is to be adopted for 2010-2012, there is no need to resolve disputes as to an appropriate risk-adjusted shared savings rate for 2010-2012.

O R D E R

IT IS ORDERED that:

1. No further proceedings shall be conducted concerning whether, or if so, how, to design an incentive mechanism for the 2010-2012 energy efficiency program cycle.

2. No incentive mechanism for the 2012-2012 energy efficiency program cycle shall be adopted.

3. No incentive earnings or penalties shall be assessed for 2010-2012 energy efficiency program activities.

4. Determinations of policies and programs to design and implement effective incentives to meet and exceed adopted energy efficiency goals for the 2013-2014 program cycle shall be pursued as a priority in this proceeding.

5. Rulemaking 12-01-005 remains open.

This order is effective today.

6. Dated ______________________________, at San Francisco, California.